DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 00-0379
Indiana Corporate Income Tax
For the Years 1994, 1995, 1996, and 1997

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ISSUES

I. **Delaware Holding Company** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); IC 6-3-2-2(m); Gregory v. Helvering 293 U.S. 465 (1935); Bethlehem Steel Corp. v. Ind. Dept of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Marshalk v. Green, 746 F.2d 927 (2d Cir. 1984); PepsiCo, Inc. v. Grapette Co, 416 F2d 825 (9th Cir. 1969); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); J. Gilson, Trademark Protection and Practice (2001); Del. Code Ann. tit. 30, § 1902(b)(8).

Taxpayer takes issue with the audit's decision to include a Delaware Holding Company and its trademark royalty income within taxpayer's Indiana consolidated income tax returns.

II. **Unitary Relationship** – Foreign Partnership.

Authority: Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 768 (1992); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Bell v. Clark, 670 N.E.2d 1290, 1293 (Ind. 1996); 45 IAC 3.1-1-153; 45 IAC 3.1-1-153(b); Black's Law Dictionary p. 1142 (7th ed. 1999)

Taxpayer argues that the Department erred when it determined that it had a "non-unitary" relationship with a "silent partner."

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of selling food and food-related specialty products to retail stores and industrial food processors. Taxpayer has a manufacturing facility in Indiana. Delaware holding company is taxpayer's wholly-owned subsidiary.

The Department of Revenue (Department) conducted an audit of taxpayer's business records and tax returns. During that audit, a number of adjustments were made which resulted in an assessment of additional corporate income tax. Taxpayer disagreed with certain of the

adjustments and submitted a protest to that effect. The Department agreed with a number of the taxpayer's arguments. However, two issues remained unresolved. An administrative hearing was conducted during which taxpayer's representatives set forth their concerns, and this Letter of Findings results.

DISCUSSION

I. Delaware Holding Company – Adjusted Gross Income Tax.

During the audit review, the Department determined that taxpayer's Delaware holding company should be included in taxpayer's combined Indiana return. The effect of this decision was to increase taxpayer's allocable Indiana income.

Taxpayer's Delaware holding company received approximately $10,000 in interest income during 1994. In 1995, taxpayer's board of directors approved amendments to Delaware holding company's certificate of incorporation. These amendments facilitated the transfer of taxpayer's trademarks to Delaware holding company. Simultaneously, a licensing agreement was entered into between taxpayer and Delaware holding company. The agreement provided taxpayer the right to make continued use of its trademarks; in return, taxpayer paid royalties to Delaware holding company. According to the audit report, "This resulted in a royalty expense that the taxpayer would not normally incur reducing [taxpayer's] apportionable income and royalty income free of state tax for [Delaware holding company]." Delaware holding company's royalty income was not taxable because that state does not tax income attributable to intangibles. *See* Del. Code Ann. tit. 30, § 1902(b)(8).

Following the amendments to Delaware holding company's certificate of incorporation and execution of the royalty agreement, Delaware holding company's income increased. In 1995, Delaware holding company received approximately $38,000,000 in royalties. In 1996, Delaware holding company received approximately $58,000,000 in royalties. During 1995, taxpayer reported royalty expenses of approximately $35,000,000 and – in 1996 – reported royalty expenses of approximately $53,000,000.

The audit review concluded that – in calculating taxpayer's Indiana income – the Delaware holding company should be included in taxpayer's combined return thereby effectively ignoring Delaware holding company's separate existence and the taxpayer's royalty expenses.

Taxpayer disagrees maintaining that the Delaware holding company is a "viable corporation having as its valid business purpose the protection, maintenance, and management of valuable intangible assets." In effect, taxpayer argues that the Delaware holding company – because it has a legitimate and independent purpose and because it has no ties with the state of Indiana – should not have been included in taxpayer's combined Indiana return.

Taxpayer manufactures and sells various food products. Associated with those products taxpayer over the years has developed certain trademarks. In 1995, taxpayer transferred ownership of the trademarks to Delaware holding company. In 1996, taxpayer and Delaware holding company entered into a "Trademark Licensing Agreement" in which taxpayer obtained the "exclusive

license to use the Licensed Marks in connection with the manufacture, distribution, promotion, advertising and sale of products in the United States." In exchange for the right to use the trademarks, taxpayer agreed to pay Delaware holding company five percent of the trademarked food product net sales.

Four days before Delaware holding company and taxpayer entered into the licensing agreement, the parties entered into an "Agreement" whereby taxpayer agreed to administer Delaware holding company's trademarks, enforce trademark protection, monitor the illegal use of the trademarks, and "[r]etain outside trademark counsel on [Delaware holding company's] behalf." In exchange, Delaware holding company agreed to pay taxpayer approximately $600,000 each year.

Summarizing, taxpayer transferred its trademarks to Delaware holding company; taxpayer licensed the trademarks back from Delaware holding company in exchange for ongoing royalty payments; taxpayer agreed to assume responsibility for the monitoring and protection of the trademarks in exchange for which Delaware holding company agreed to make monthly payments to taxpayer.

During 1996 and 1997 taxpayer paid Delaware holding company approximately $90,000,000 in royalty payments. However, based upon the information available, Delaware holding company did not retain the $90,000,000. Based upon a pre-existing 1991 "Loan Agreement," Delaware holding company – as a "wholly owned subsidiary of [taxpayer]" – agreed to make loans to taxpayer "from time to time" and for "any amount requested by [taxpayer]."

Although the details of any loans made pursuant to the "Loan Agreement" are unavailable, it is apparent that the royalty payments were not retained by Delaware holding company but were loaned to taxpayer. In addition – as previously noted – Delaware holding company paid taxpayer monthly "fees for services" because taxpayer had reassumed responsibility for protecting and monitoring the trademarks.

On the ground that the trademark arrangement was entered into "for the sole purpose of transferring allocable income from [taxpayer] to [Delaware holding] thru the creation of an expense that would not normally be incurred," the audit review imposed a unitary filing requirement under authority of IC 6-3-2-2(m) which provides as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from the language contained with IC 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the unitary reporting method of which taxpayer complains – are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

The audit was clearly justified in determining that permitting the taxpayer to classify the royalty payments as business expenses artificially distorted taxpayer's Indiana income. The plain language of IC 6-3-2-2(l) states that "[i]f the allocation and apportionment provisions of this article do not fairly represent that taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the taxpayer's business activity* . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (*Emphasis added*). Other than the hoped-for favorable tax consequences, the transfer of the trademarks to Delaware holding company and the subsequent licensing agreement appear to have no discernible business purpose. There is nothing to indicate that taxpayer's business operation was in any way affected by the transfer of the trademarks. There is nothing to indicate that the Delaware holding company exercised any independent ownership of the trademarks. There is nothing to indicate the Delaware holding company had any experience in or was qualified to develop, manage, or exploit intellectual property such as these trademarks. There is nothing to indicate that Delaware holding did anything to manage these trademarks, work to enhance the value of the trademarks, or protect the trademarks. Indeed by the terms of the parties' ancillary 1996 agreement, taxpayer had reassumed the responsibility for administering and protecting the trademark properties.

In addition, the audit – in determining taxpayer's taxable income – would have been justified in simply ignoring the $90,000,000 royalties payments on the ground that the payments stemmed from a "sham transaction."

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by

the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied,* 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, *ex ante,* for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1337.

Taxpayer maintains that the royalty/trademark/license/loan agreement[s] all had an "economic substance," that Delaware holding company "incurs operating costs, contracts in its own name, and holds and manages intangible assets." Further, taxpayer maintains that the royalty payments amounts - $90,000,000 in two years – are "based on arms length and commercial rates and terms." The Department has no reason to doubt taxpayer's veracity or its good faith; however, it is evident that the royalty payments were made for no other discernible "motive but to escape taxation." Commissioner 176 F.2d at 572. There is no evidence that these various transactions entered into by taxpayer and Delaware holding company added anything of value to the trademarks, increased taxpayer's profits, or had any other business purpose outside of obtaining tax benefits. The Department would have been justified in ignoring the trademark transfers and subsequent royalty payments because they were based on a "sham transaction."

Further, the notion that the trademarks in questions – essentially, a collection of approximately 120 brand names attached to various foods items – have any transferable value once severed from the food items, is unsupported in law, practice, or simple business reality. Taxpayer's assumption that it can sever the trademarks from their associated products and then transfer those marks is flawed because a trademark "is merely a symbol of goodwill; it has no independent significance apart from the goodwill it symbolizes." Marshalk v. Green, 746 F.2d 927, 929 (2d Cir. 1984). "There are no rights in a trademark apart from the business with which the mark has been associated; they are inseparable." Id. The trademarks themselves have no independent value because the trademarks are simply advertising tools symbolizing customer good will and the customer's willingness to purchase – and repurchase – the taxpayer's products. J. Gilson, Trademark Protection and Practice 1.03[6][a] (2001). The fact that the independent evaluation placed a "value" on the trademarks, is insufficient to establish that the transfer of the trademarks to the Delaware holding company was anything more than an exercise in empty legal formalism.

The audit was justified in including the Delaware holding company in taxpayer's combined Indiana return in order to more fairly reflect taxpayer's Indiana income. The audit would have been equally justified in ignoring the tax effects of the royalty payment and interest deductions because the royalty payments, license agreement, loan agreement were all part of a "sham

transaction." In addition the audit would have been justified in ignoring the tax consequences of the royalty and interest payments because the initial transfer of the trademarks and the consequent royalty payments was entirely illusory. The transfer of the trademarks to the Delaware holding company was illusory because the trademarks have no value distinct from the taxpayer's goodwill. The royalty payments were illusory because the taxpayer was paying for something which had no existence independent from the taxpayer's own commercial activity. PepsiCo, Inc. v. Grapette Co, 416 F2d 825, 288 (9th Cir. 1969). The transfer of the trademarks to the Delaware holding company was illusory because the holding company was incapable of managing or exploiting the intellectual property irrespective of the subsidiaries' business activities. The royalty payments were illusory because the holding companies simply "loaned" the money back to the taxpayer.

With all due respect to taxpayer best intentions, the entire arrangement – the "Trademark License Agreement," the "Loan Agreement," the trademark protection "Agreement," the substantial royalty payments – constitute nothing more than an elaborate form of corporate three-card monte. Taxpayer is, of course, entitled to structure its business affairs in any manner it deems appropriate and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992).

FINDING

Taxpayer's protest is respectfully denied.

II. Unitary Relationship – Foreign Partnership.

Taxpayer has a partnership arrangement with a foreign company. The foreign company has no Indiana presence. According to taxpayer, it is a "limited partner" in the foreign company. Taxpayer states that the foreign company is dormant and has conducted no business for a number of years. However, because the partners wish to keep this foreign company in good standing, the foreign company incurs routine ongoing administrative expenses. Taxpayer contributes cash to pay for these costs. According to the terms of the partnership agreement, taxpayer is entitled to 100 percent of the foreign company's losses up to the amount of contributed capital.

The audit found that the foreign company was a "limited partnership" and also describes the foreign company as a "silent partnership." Therefore, the audit concluded that taxpayer and foreign company did not have a unitary relationship and that the partnership losses – the money paid to pay the administrative expenses necessary to maintain the foreign company's existence – should be deducted from schedule B of the taxpayer's Indiana return and be treated as non-business income or loss.

45 IAC 3.1-1-153 is determinative of whether or not a unitary relationship exists. "If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary

business attributable to Indiana shall be determined by a three (3) factor formula . . . ." 45 IAC 3.1-1-153(b). Therefore, in order to establish a unitary operation, the taxpayer must demonstrate that the relationship between itself and the partnership meet the established standards of a unitary relationship.

The unitary principal has been addressed repeatedly by the Supreme Court; while no single definition exists, one characteristic appears to be essential – day-to-day operational control. Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 768 (1992); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982). To establish that taxpayer does have a unitary relationship with the partnerships, taxpayer must establish taxpayer has operational control of the partnerships or that management of the partnerships is centralized with the taxpayer.

The foreign company is a "limited partnership," and the taxpayer is a "limited partner." A limited partnership is one in which some of the partners control the business and are personally responsible for the partnership's debits. Black's Law Dictionary p. 1142 (7th ed. 1999). The other participants – such as taxpayer – are limited partners who "contribute capital and share profits but who cannot manage the business and are liable only for the amount of their contribution." Id. Such an arrangement enables the limited partners "to invest their money in a business without taking an active part in managing the business, and without risking more than the sum originally contributed . . . ." Id. at p. 1143. *See also* Bell v. Clark, 670 N.E.2d 1290, 1293 (Ind. 1996).

Because taxpayer is a limited partner in the foreign business, by definition it exercises no day-to-day operational control. Operational control is an essential element in establishing a unitary relationship. Container Corp. of America 463 U.S. at 165-66. Therefore, because the taxpayer does not have a unitary relationship with the foreign company, the audit review correctly determined that the losses were "non-business income" and should be eliminated from the taxpayer's Indiana return.

FINDING

Taxpayer's protest is respectfully denied.

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